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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Bolivia: Economic Problems Facing the Banzer Government

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
January 1972

INTELLIGENCE MEMORANDUM

BOLIVIA:
ECONOMIC PROBLEMS
FACING THE BANZER GOVERNMENT

Summary and Conclusions

1. The government of Colonel Hugo Banzer Suarez, which came to power in a bloody revolt on 22 August 1971, has made progress in reviving business confidence and restoring good relations with the United States. The populist and extreme nationalist policies of the preceding regimes of Generals Alfredo Ovando and Juan Jose Torres have been largely abandoned, and compensation settlements have been nearly reached for two of three nationalized US business properties. Progress in coping with the politically difficult economic problems inherited from Torres, however, has been slow, and some indications of drift have been apparent. A large 1971 budget deficit is being met with stop-gap measures, including central bank financing, which could endanger price stability, hamper private investment recovery, and lead to increased balance-of-payments strains. Although sizable foreign economic assistance offers, especially from the United States, eventually will be beneficial, they provide little help in meeting the immediate deficit problem.

2. President Banzer will have difficulty avoiding an even larger budget deficit next year. Public investment is slated for a large increase to help accelerate economic growth and reduce unemployment, and the large carryover of unpaid 1971 bills compounds the problem. Vigorous action to ease budget difficulties is opposed by members of his cabinet, and Banzer probably believes that such action would threaten the government's already fragile cohesion. Thus, although Bolivia is subject to international pressures to straighten out its fiscal affairs, Banzer possibly will avoid decisive action, relying on Washington to bail him out some time

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Note: This memorandum was prepared by the Office of Economic Intelligence and coordinated within CIA.

next year. Moreover, any longer-term solution to the country's economic problems will require gaining the confidence of both domestic and foreign investors – a formidable task in view of Bolivia's political history.

Discussion

Economic Policy Under Torres

3. General Juan Jose Torres' seizure of power in October 1970 – Bolivia's third leadership change in less than two years – immediately followed a bungled coup by rightist military leaders against the moderately leftist government of General Alfredo Ovando. Distrusted by business and most military leaders, Torres during his ten months in office looked increasingly to extreme leftist labor unions and students for support. Amid promises of improved living standards through greater state control of the economy, Torres boosted miners' and factory workers' pay, placed marketing of several major crops under government control, nationalized two of Bolivia's four sugar mills, and threatened to take over other private domestic holdings in banking, electric power, and manufacturing. When his anti-business policies encouraged mounting labor disturbances, he failed to forcefully use state powers to restore order.

4. Blaming Bolivia's backwardness on "imperialist domination," Torres accelerated the movement against US-owned business properties initiated when Ovando nationalized the Bolivian Gulf Oil Company properties in October 1969.* In January 1971 he took over the $3 million properties of the International Metal Processing Company (IMPC), and in June he nationalized the $12 million properties of the Matilde Mining Corporation, a zinc-mining subsidiary of US Steel and Engelhard Mining and Chemicals. Pressure against US firms intensified when armed bands of leftists occupied, without opposition from Torres, the gold-dredging facilities of the South American Placers, Inc., and the zinc-mining properties of the Gibralter Huari-Huari Mining Corp. Torres publicly reaffirmed the Gulf compensation settlement reached by Ovando and promised full compensation for the Matilde and IMPC properties, but he did little to fulfill these pledges before his overthrow.

5. To promote Bolvia's independence from "imperialist hegemony," Torres continued the expansion of relations with Communist countries initiated by the Ovando government. During their regimes, trade and

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diplomatic relations were established with the USSR and five East European Communist countries. Exports to Communist countries rose from $2 million in 1969 to $10 million in 1970 – about 5% of total export earnings – and entailed some diversion of tin sales from traditional markets. Bolivia obtained offers of $56 million in Communist economic assistance, including a $27.5 million Soviet credit covering four tin volatilization plants and other mining projects and a $4 million Czech credit for an antimony smelter now nearing completion.

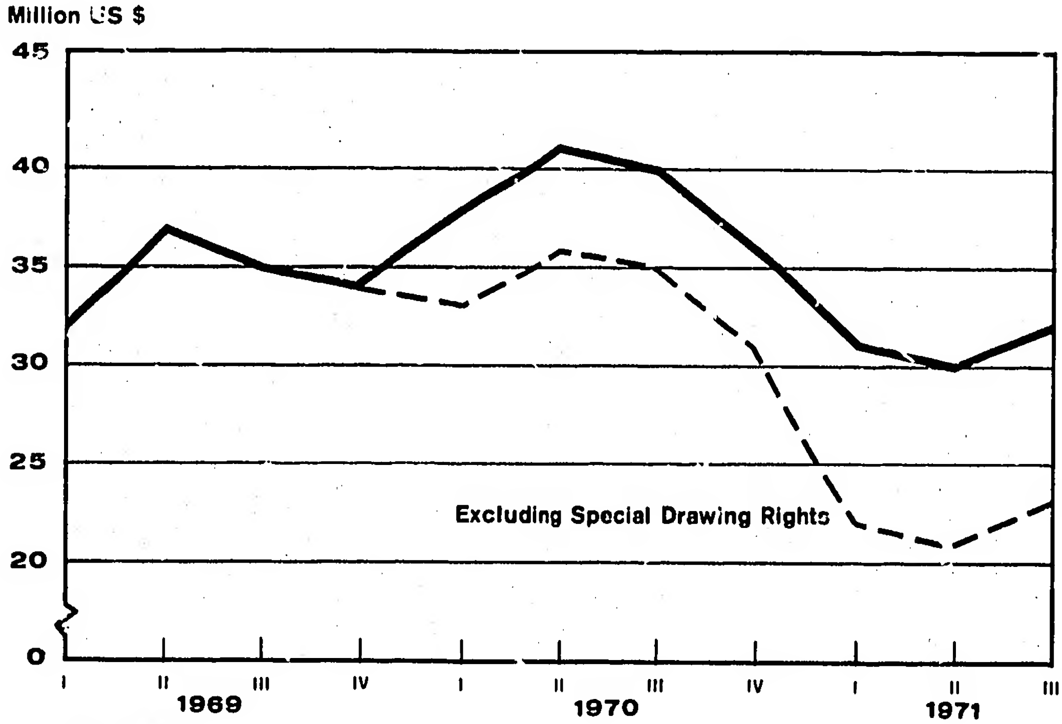
The Economy's Course in 1970-71

6. Torres' measures shook business confidence, which had just begun to recover from Ovando's Gulf nationalization. From 1969 to 1970, private investment fell 20%, and in the first three quarters of 1971 probably declined even more. Net direct foreign investment inflows, which had averaged $6.5 million annually during 1966-69, dried up, and the availability of foreign supplier credits from non-Communist sources dwindled. Public investment also dropped sharply in 1970 and apparently fell further in early 1971. By August 1971, construction had come to a standstill, and the unemployment rate – already at 22% of the urban labor force in February -- had grown further.

7. Despite a 21% rise in Bolivia's export prices in 1970, balance-of-payments strains became evident after mid-year and mounted sharply in the first six months of 1971. Although imports were at reduced levels throughout the period, short-term capital flight and the drying up of long-term capital inflows caused payments deficits in the last two quarters of 1970. Together with declining export prices, these factors induced even larger deficits in the first two quarters of 1971. Net foreign exchange reserves dropped from $41 million on 30 June 1970 to $30 million at the end of June 1971. The decline would have been even more pronounced had Bolivia not received an additional $4 million in Special Drawing Rights in January 1971 (see the chart). Reserves recovered slightly in the third quarter of 1971 because of a windfall refund under the International Tin Agreement but still were sufficient to cover only about two months' imports.

8. Government fiscal performance remained strong through the end of 1970 but deteriorated sharply in the first eight months of 1971. Although Ovando granted a large teachers' pay hike in September 1970, expenditures were held in check -- mainly by cutting public investment – and the budget deficit was reduced to 14% of expenditures, compared with 18% in 1969. In 1971, however, revenue growth slowed while expenditures grew sharply, despite continued low public investment. Outlay growth was sparked by higher teachers' salaries and greatly increased transfers to the State Mining

Bolivia: Net Foreign Exchange Reserves*



*End of period

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Company (COMIBOL) to cover its sharply rising wage bill. By August 1971 a budget deficit equivalent to some $40 million, or about 30% of expenditures, was in prospect for the year. Monetary restraint – largely at the expense of private sector credit – permitted continued price stability throughout the period but contributed to a substantial reduction in the economic growth rate.

The Banzer Government's Policy Orientation and Initial Moves

9. The Banzer government – an unlikely coalition of military officers, businessmen, and traditionally antagonistic political parties – lost no time seeking foreign financial backing and a strengthened political base. Striking a moderately nationalistic posture, it announced that the Gulf, Matilde, and IMPC nationalizations were "irrevocable" and that Gibralter would be made a joint state-private enterprise but promised that prompt

steps would be taken to effect satisfactory compensation settlements. The government also stated that new foreign investment was welcomed and, while subject to "new responsibilities," would receive adequate guarantees and new financial incentives. At the same time, the government affirmed that Communist-financed projects initiated under Torres would not be suspended, because capital from any source was desired so long as it met Bolivia's needs.

10. To maintain its own security and to consolidate its support from moderate elements, the Banzer government jailed or drove into exile most far-leftist labor leaders. It also eliminated union participation in the management of COMIBOL and other state enterprises and announced that the unions would be reorganized on a "depoliticized" basis. The marketing of coffee (but not other crops) was removed from state monopoly and restored to the private sector. The government maintains that continued state planning and control is necessary to Bolivia's development and advocates the formation of some joint state-private enterprises with majority state control. Nevertheless, it has guaranteed continued operation of privately owned mines (which still account for about half the metallic mineral output) and promised to reserve other economic spheres for private ownership. The Banzer government's restraint regarding politically inspired promises to redistribute income and the greater emphasis on accelerating economic growth and reducing unemployment also have pleased business interests. The business community, which played an important role in financing Banzer's takeover, responded to the government's posture by adopting self-imposed price controls on manufactured goods and promising to expand investment immediately.

11. In an effort to restore good relations with the US Government and improve the investment climate, the government moved quickly to undo some of the damage caused by the Torres government's attacks against foreign businesses. It drove the armed squatters from the US-owned mines, proposed satisfactory compensation settlements for IMPC and Gibralter, and is negotiating with the Matilde mine owners. It also took a step toward fully indemnifying Gulf by completing arrangements for $42 million in foreign assistance to finance a gas pipeline to Argentina. Revenues from these gas sales – according to the 1970 settlement – are to provide most of Gulf's compensation. In other efforts to reassure foreign investors, the Banzer government promised to seek "greater flexibility" in the Andean Foreign Investment Code as it applies to Bolivia and appointed a commission to revise the Bolivian Mining Code to give private investors greater latitude.

12. By current Latin American standards, the Banzer government has agreed to relatively liberal compensation for nationalized foreign properties. Under the IMPC settlement, as yet unsigned, the government will pay $1.5 million in cash to cancel all prior owner claims, and a new joint venture

with a 55% government share will be established to operate the IMPC facilities, which are to be enlarged. In addition to their 45% share in the profits, which will be taxed at the rate for medium-sized private mines, the US owners will receive $20,000-$25,000 monthly for managing the facilities and for use of their patents. Full ownership of the facilities and patents will revert to the government in ten years. The settlement's main features -- cash payment for prior claims, majority state ownership in the new joint venture, the managerial service contract, and the ten-year "fade out" provision -- also are included in the Gibralter agreement, and the government plans to apply them in the Matilde settlement as well.

The Role of Foreign Aid

13. Because of its moderate policies and forthright action to settle nationalization cases, the Banzer government can count on significant foreign economic assistance. The US Government has provided a $22 million aid package -- including an immediate $2 million grant, a $12 million program loan, and an $8 million agricultural loan. Moreover, in addition to the $42 million gas pipeline loan approved by the World Bank and the Inter-American Development Bank (IDB), some $37 million in development funds have been made available from these two international agencies and several Latin American and European countries. Several Communist countries have confirmed aid deals originally extended the Torres regime.

14. Foreign lenders' requirements, however, pose serious obstacles to Bolivia's utilization of most of the economic assistance proffered. Only the $2 million US grant directly helps the Banzer government in dealing with the large budget deficit -- its most immediate problem. Utilization of the non-US aid, in fact, will exacerbate the budget problem because Bolivia is required to finance the local costs of the projects involved. Even the usefulness of the US program loan (which does not involve Bolivian counterpart expenditures) is severely limited by the requirement that the funds be used only for public investment projects. Financing the few active investment projects inherited from the Torres regime would absorb only a fraction of the $12 million involved, and the severe shortage of experienced technical personnel has hampered the drawing up of new projects.

Problems and Options

15. Despite the Banzer government's forward movement on some fronts, Bolivia's chances of easing its economic problems seem dim and its options limited -- perhaps even more than usual. The scanty information available does not suggest that private investment has fully revived. This situation may reflect continuing credit and other commercial difficulties

or, more likely, reaction to unsure political prospects. Although the Banzer government has reduced the prospective 1971 budget deficit by approximately one-fourth through expenditure cuts, it has resorted mainly to stop-gap measures to finance the still large remaining deficit of some $30 million. This financing has required increases in the floating debt, borrowing against counterpart accounts, and central bank borrowing; part of these funds will have to be repaid next year. As of early November, the equivalent of about $8 million still remained to be covered, possibly by further central bank borrowing.

16. Excessive recourse to central bank financing could have serious implications for private investment or price stability – or both. Increased credit to the government would require either further curtailment of credit to the private sector, thus holding back any upswing in private investment, or a more expansionary monetary policy that would raise prices if imports could not adequately supplement domestic supply. Net foreign reserves undoubtedly have risen since 30 September and will continue to benefit from aid disbursements. Nevertheless, a sharp rise in imports could worsen the reserve position, forcing the government to choose between balance-of-payments problems and the price rises that are almost irrationally feared by many Bolivians because of the runaway inflation in the early 1950s.

17. Avoiding an even larger budget deficit next year will be difficult. The 1972 budget provides for a large rise in investment outlays to further President Banzer's goals of stimulating economic growth and alleviating unemployment. Unless the government takes some counteraction, this investment increase and the carryover of unpaid 1971 bills will boost the deficit to at least $50 million. Less than one-third of this deficit is likely to be financed with foreign assistance funds. Moreover, the government apparently assumes that receipts from export taxes and COMIBOL profits will rise, or at least remain firm. If world prices for Bolivia's mineral exports continue to decline (as seems likely) or if labor disturbances hurt mining output, the deficit would be even larger.

18. President Banzer has several alternatives for reducing the deficit, all of which are being opposed by various members of his cabinet. For example, he could increase taxes. Several cabinet members, including the business community's principal representative, have sought, however, not only to avoid increasing taxes but to find ways of reducing them. Nor are many cabinet members likely to favor paring noninvestment outlays, since this would require curtailed government services or reduced pay rates for miners, teachers, and other public employees. A major peso devaluation, as recommended by the International Monetary Fund (IMF), would ease Banzer's budget problems greatly by increasing state mine profits and tax

revenues from private mines and would have some beneficial effect on the balance of payments. Devaluation, however, could have a seriously adverse political impact because it would boost the cost of living by increasing the price of imports. Several cabinet members are opposed to a devaluation, and many Bolivians take pride in having held to the same exchange rate since 1958. The general currency realignment presently under way obviously would provide the opportunity for a major peso devaluation with minimum domestic political impact. Although the government has not yet announced its response, it probably will at least maintain parity with the dollar. Such an adjustment would provide only marginal balance-of-payments benefits.

19. Thus any route Banzer chooses will carry political risks. He probably believes that strong action to cut the budget deficit would disrupt the tenuous cohesion of the present ruling coalition. If the military remained unified, this development might pose no real threat to Banzer's tenure, since the military continues to provide the muscle behind the government. But there are already indications that part of the military is not satisfied with some of Banzer's actions. Consequently, it is possible that – as predicted by a recent IMF team – Banzer will take no action at all to cut the deficit. Although his requests for budget assistance have been refused repeatedly, he may still count on the United States to bail him out sometime in mid-1972. Banzer continues to hope that the United States has a special interest in avoiding another left-wing Bolivian goverment.

20. Significant progress in solving Bolivia's longer-term problems of impoverishment and underemployment will require a much greater improvement in the investment outlook than the country's political instability seems likely to permit. Because domestic resources are so limited, development depends largely on the availability of foreign capital, which under the best of circumstances finds little to attract it in Bolivia. Widespread disbelief in the permanence of the Banzer government – or those that may succeed it – further reduces the help that can be expected from private investors. Political uncertainty and the country's financial and institutional poverty will also adversely affect both the amount and the effectiveness of economic assistance. To the extent it is unable to meet the requirements levied by foreign lending agencies, Bolivia will be forced to rely on grants and other "soft" foreign aid which are likely to be available only in limited amounts.